Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:MAN:2:TL-N-3919-01
PLDarcy; DARosen

date: August 22, 2001

to: Territory Manager, Retailers, Food and Pharmaceuticals
(San Francisco, California)
Attn: Revenue Agent Linda Cholcher, Team Coordinatior

from: Area Counsel (Financial Services)

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subject: [redacted]

Taxable Years Ended [redacted] through [redacted]
U.I.L. No. 41.51-02

This memorandum responds to your request for advice on whether payments by [redacted] ("[redacted]") to the [redacted] may be treated as qualified research expenses ("QREs") pursuant to section 41(b)(1)(B),[1] and has been coordinated with the Pharmaceutical Industry Counsel. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. This memorandum should not be cited as precedent.

ISSUE

Whether [redacted]'s payments to the [redacted] may be treated as QREs.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

FACTS

The Large and Mid-Size Business Operating Division (Retailers, Food and Pharmaceuticals) is currently auditing the [redacted] through [redacted] taxable years of [redacted] ("[redacted]"). During these years, [redacted] was a consolidated subsidiary of [redacted] and produced [redacted] products. [redacted] also had a small pharmaceutical business during these years. In [redacted], [redacted] spun-off [redacted]'s pharmaceutical business, [redacted], to another consolidated subsidiary called [redacted].

[redacted]

Starting in [redacted], [redacted] gave certain funds to the [redacted]. Enclosed with each [redacted] remittance to the [redacted] was a letter from [redacted] unequivocally stating the remittance was "an unrestricted gift to the [redacted]."

In [redacted], [redacted] researchers published a study in a publicly available journal called "[redacted]." The study was entitled "[redacted]" (the "[redacted]"). At the end of the study, the [redacted] researchers stated that "[t]his study was supported by a grant from [redacted]" (emphasis added).

At no time prior to the performance of the [redacted] did [redacted] and the [redacted] enter into an agreement that the [redacted] would perform research on [redacted]'s behalf. To the contrary, the remittances made to the [redacted] were in the form of unrestricted gifts as discussed supra. However, on its consolidated returns for the years at issue, [redacted] claimed a contract research expense for the funds that [redacted] remitted to the [redacted].

The Examination Team has determined that [redacted]'s remittances to the [redacted] may not be treated as QREs. Rather, the Examination Team determined that the remittances to the [redacted] were charitable contributions under section 170.[2]

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[2] This memorandum does not address whether the remittances to the [redacted] constitute a charitable contribution.

Moreover, [redacted] products were generally marketed prior to [redacted], and the Examination Team has determined that the effects of [redacted] on humans were well known prior to [redacted]. Therefore, the Examination Team alternatively determined that the [redacted] does not constitute a qualified research activity pursuant to section 41(d).[3]

DISCUSSION

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under section 41(e)(1)(A)[4]. Section 41(b)(1) defines QREs as the sum of (1) "in-house research expenses" and (2) "contract research expenses." The only issue in this case is whether [redacted]'s payments to the [redacted] may be treated as "contract research expenses."

Section 41(b)(3) defines "contract research expenses" as 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research. Section 41(d) defines qualified research as research:

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information-

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

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[3] The Examination Team has determined that the activities in question do not constitute "qualified research" as defined in section 41(d). This is based on the Examination Team's factual findings and technical knowledge. Accordingly, this memorandum does not address this issue.

[4] Under section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in section 41(d)(3). Section 41(d)(3)(3) states that the research must relate to (i) a new or improved function, (ii) performance, or (iii) reliability or quality.

Section 1.41-2(e) of the Regulations provides a three-part test for determining if the payment is for the performance of qualified research where a third party performs the research for the taxpayer. Section 1.41-2(e)(2) of the Regulations provides that an expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that-

(i) is entered into prior to the performance of the qualified research;

(ii) provides that research be performed on behalf of the taxpayer; and

(iii) requires the taxpayer to bear the expense even if the research is not successful.

Section 1.41-2(e)(3) of the Regulations provides that qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results. Id.

ANALYSIS

Contract Research Issue

In order for [redacted] to treat the amounts remitted to the [redacted] as contract research expenses, it must establish that the amounts were remitted (1) pursuant to an agreement entered into prior to the [redacted]; and (2) that this agreement gave [redacted] a right to the results of the [redacted]. Treas. Reg. §§ 1.41-2(e)(2)(i) and (ii).

As a preliminary matter, the evidence indicates that there was no agreement, at any time, between [redacted] and the [redacted] for the performance of the [redacted]. To the contrary, [redacted]'s letters show that remittances it made to the [redacted] were simply unrestricted gifts. If the [redacted] chose not to use the unrestricted gift for the [redacted], [redacted] would by the very terms of its remittance have no legal recourse against the [redacted]. Thus, we do not believe that [redacted] can successfully argue that it had an agreement with the [redacted], entered into prior to the performance of research, for research as required by section 1.41-2(e)(2)(i) of the Regulations.

Moreover, the evidence indicates that any "right" that [redacted] may have arguably had to the [redacted] inured after the research was performed by the [redacted], and thus fails to meet the requirements of sections 1.41-2(e)(2)(ii) and (3) of the Regulations. Taken together, these provisions require that [redacted]'s right to the results of the [redacted] arise pursuant to an agreement entered into before the performance of the [redacted]. However, at no time prior to the performance of the [redacted] (as discussed supra) did [redacted] and the [redacted] enter into any agreement that the [redacted] would perform the [redacted], let alone such a prior agreement that [redacted] would have a right to the results. After the [redacted] was completed, the results were published by the [redacted] in a publically available journal, giving all who purchased the publication equal rights to the research results. The fact that the [redacted] made the results of the [redacted] available, of its own volition, to [redacted] and to the general public after its completion does not establish that the research was performed "on behalf of" [redacted]. Treas. Reg. §§ 1.41-2(e)(2)(ii) and (3).

Qualified Research Issue

The Examination Team alternatively determined that the [redacted] does not constitute a qualified research activity pursuant to section 41(d).[5] Based on this determination, the payments made by [redacted] to the [redacted] may not be treated as QREs. I.R.C. § 41(b)(3).

[5] Supra note 3.

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This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions regarding the above, please contact Paul Darcy of this office at (212) 264-5473 x256.

ROLAND BARRAL
Area Counsel

By: /s/
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(LMSB)